How independent are independent committees and advisers in Mergers and Acquisitions transactions?

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by Jonathan Mukwiri

Jonathan Mukwiri is a senior lecturer at Durham University with research interests in company and commercial law. Email: jonathan.mukwiri@durham.ac.uk

Abstract:
Independent Committees in the US are more likely to be scrutinised by the courts than their counterpart Independent Advisers in the UK after or during mergers and acquisitions. Stockholders are more likely to bring actions against Committees in the US for unfairness in the transaction than shareholders may bring against Advisers. Whilst the use of Independent Committees may clear boards of charges of unfairness in handling transactions, it cannot cure fraud. This article considers the role of independent committees and advisers in Mergers and Acquisitions in light of the Delaware Court of Chancery case (Dole Foods Co Inc).

KEY POINTS

· While in the US, the question of the independence of Committees or Advisers is decided through litigation in the courts, UK practice and law prevents such litigation.

· Both Delaware courts and the UK Takeover Panel are likely to find Committees or Advisers to be independent notwithstanding they have a connection or an advisory role with the offeror; the Panel's approach has become more flexible as financial advisers and companies enter less exclusive relationships

· The judge in *Dole* reiterated a common law rule – fraud unravels all – in finding that an Independent Committee cannot cure fraudulent actions of the board in a merger transaction.

INTRODUCTION

In mergers and acquisitions where management are interested, there is potential for conflict of interests if the same management board advise the shareholders on the merits of the proposal. In the US, in order "to reduce the conflict of interest, directors often establish a special committee of disinterested directors to evaluate the management proposal" (Bill Shaw (1990) 19 Hofsra Law Review 143, 155). The use of Independent Committees in such transactions has a long history, and the independence of such committees have been the subject of debate for a long time. In the UK, managerial conflicts of interests in such transactions are unlikely to cause issues because the rules contained in the Code on Mergers and Takeovers prevent this by giving "almost complete authority to shareholders" (Armour and Skeel (2007) 95 Georgetown Law Journal 1727, 1730). The rules also require boards to take independent advice in giving their opinion to shareholders. This article compares the role of Independent Committees (in the US) with that of Independent Advisers (in the UK).

The role of Independent Advisers in the UK has not been much debated compared to the counterpart role of Independent Committees in the US. Questions that have dominated the US debate have included what counts as independent, and what are the limits of such independence. The judgment of the Court of Chancery of the State of Delaware in *Re Dole Food Co Inc* (Consolidated Nos 8703 and 9079 of 27 August 2015) reiterates the effect of fraud.

This article proceeds as follows. First, it compares the different regulatory approaches in the US and UK under which Committees and Advisers operate. Second, it considers, in light of the *Dole* case, the following issues regarding the use of Independent Committees (US): what counts as independent; which decisions should the committee make and which should be passed back to the target's board; and whether there are any steps committees can take to protect the company from aggressive bidders acting in bad faith. Third, it discusses the role of Independent Advisers in the UK, noting particularly the unlikelihood of court scrutiny. The last section concludes.

DIFFERENT REGULATORY APPROACHES

It is worth providing a brief background to the rather different regulatory approaches in the UK and US, and the different powers that boards in the UK and US have during mergers or takeovers. The difference in UK and US approaches is well explained in the seminal work of Armour and Skeel (2007 Georgetown Law Journal 95:1727). In the UK, takeovers are governed by the Takeover Panel, which administers the rules in the Takeover Code. In contrast, most takeovers in the US are governed by the courts of Delaware. In the UK, the board is prohibited under the board neutrality rule (Code, rule 21) from frustrating a bid without shareholders' approval. In contrast, the board in the US may, without prior stockholders' approval, take defensive measures to frustrate a bid, as long as the measures are a justifiable discharge of their fiduciary duties.

The roles of a UK Independent Adviser and a US Independent Committee are also different. In the UK, the Independent Adviser advises the board, who in turn advises the shareholders, on the merits of the offer. The board is required (Code, rule 25) to provide shareholders with a reasoned opinion on the merits of the offer, and the role of Independent Advisers is to assist the board in forming that reasoned opinion. It is ultimately for the shareholders to decide on whether to accept or reject the offer. In contrast, in the US, the Independent Committee is vested with board-like powers to negotiate the offer on behalf of either the stockholders (in management buyouts) or minority stockholders (in offers **[*100]** by controlling stockholders). With the UK Independent Advisers' role being merely advisory, there is less potential for liability to shareholders. This is the converse for Independent Committees in the US, with stockholders more likely to bring action against them for unfairness in the transaction.

With particular reference to Advisers, the US and UK approach to apportioning liability is likely to be the same. In *Re Dole Food Co Inc*, the plaintiff sought to attach liability to Murdock's financial Adviser, Deutsche Bank Securities Inc ("DBS"). Although DBS acted improperly by favouring Murdock and treating him as the bank's real client, even though DBS was representing Dole, the court found that DBS had not participated knowingly in the breaches that led to liability. The same results were reached in *Gesoff v IIC Industries Inc* (Nos 19473 and 19600, Del Ch, May 18, 2006). Here, a sole special committee member had violated his fiduciary duty of care in approving the merger, but had acted in good faith and had not derived an improper personal benefit. He was not liable mainly because he was kept unaware of key facts that made the merger process unfair from a procedural point of view.

If the *Dole* situation was to be decided in the UK, DBS would first need to be considered as an Independent Adviser. In the UK, "a prospective adviser to an offeree company might not be considered sufficiently independent, for example, if it has had a recent advisory role with the offeror or has a very close advisory relationship with a large shareholder in the offeree company" (Takeover Panel, Annual Report 1995). Advisers may still be independent notwithstanding their close relationship (Practice Statement, 7 March 2008). Where matters that would attract liability hinge on the independence of Advisers, these are dealt with at the early stages through consultation with the Takeover Panel. Given the process, it is unlikely that the *Dole* situation in reference to Advisers' liability would be an issue in the UK.

INDEPENDENCE OF INDEPENDENT COMMITTEES

In the US, the function of independent advisers in mergers and acquisitions is assigned to Special Committees. The use of Special Committees was recommended by the Delaware Supreme Court in *Weinberger v UOP Inc* (457 A.2d 701 (Del. 1983)), where in finding that the parent-subsidiary merger was unfair to the subsidiary's minority stockholders, the court opined that the defendants' claim of fair dealing would have been enhanced by use of "an independent negotiating committee of outside directors."

There are no fast and hard rules to having Special Committees. Usually, Special Committees are appointed where the bidder is an insider or major or controlling stockholder of the target company. The role of Special Committees is to help the board overcome potential for conflict of interests. To promote the independence of Special Committees, the practice is to have persons who are not on the board and not nominees of the bidder. But the independence of Special Committees may remain intact notwithstanding it is currently connected or had a recent connection with the offeror, as was the case in *Dole* (below).

The courts have stated that determining "the composition of the special committee is of central importance" and should be approached conscientiously and with a view to minimising risk (*Gesoff v IIC Indus Inc* (902 A.2d 1130, 1145-1146 (Del. Ch. 2006). What counts as independent includes the following: disinterested members; no conflicts of interests; no benefit to be gained from a certain outcome; and must give due care. Whether a person is independent and disinterested should be tested at the outset and continuously monitored. Testing can include questionnaire or in-person/telephonic interviews. However, the Committee as a whole may be regarded independent even though some members are interested. This was the case in *Dole* (below) where the Committee was found to be independent even though the Committee Chair was well connected to the offeror.

But how independent should the Independent or Special Committee be? In Delaware, an earlier view, albeit directed at litigation committees, suggested that Special Committees "should, like Caesar's wife, be above reproach" (*Lewis v Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985). To be above reproach, independent advisers must be at arm's length with the controlling party.

"Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences" (*Aronson v Lewis*, 473 A.2d 805 (Del. 1984)). A director lacks independence if they are "beholden" to the interested party or interested director(s), or is so under such party's or person's influence that the director's "discretion would be sterilised" (*Rales v Blasband*, 634 A.2d 927, 936 (Del. 1993)).

Independent Committees make a number of decisions including: evaluating the bid (value of the company, fairness of the bid, and long term plans of the company); negotiating the bid; defending against an unwanted takeover; and appointing independent legal and financial advisors. When decisions should be passed back to the board will depend on the special facts of each case. It may depend on the level of the conflict of interests of the board of directors in the particular transaction. It may depend on the expertise and knowledge of the Committee. However, if the use of a Special Committee in the first place is to avoid potential conflicts of interests of the board, it follows that it is best that the Committee makes all the decisions.

There should be demonstrable independence, otherwise dissatisfied stockholders may challenge the transaction as unfair. In *Kahn v Lynch Communication Systems Inc*, the Delaware Supreme Court opined that where the transaction is approved by a committee of independent disinterested directors, there is a presumption that the transaction was fair, and it is for stockholders who challenge the fairness to prove otherwise (638 A.2d 1110 (1994)).

Considering that Independent or Special Committees make decisions in place of the board, the Committee can be sued by stockholders and the court would review the transaction. It was stated in *Emerald Partners v Berlin* (787 A.2d 85, 89 (Del. 2001)), that where, after a stocks transaction, stockholders challenge actions by a board of directors, generally one of three standards of judicial review is applied: (i) the traditional business judgment rule, (ii) an intermediate **[*101]** standard of enhanced judicial scrutiny, or (iii) the entire fairness analysis.

The business judgment rule is a presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in honest belief that the action taken was in the best interests of the company" (*Aronson v Lewis*, 473 A.2d 805, 812 (Del. 1984) – overruled on other grounds by *Brehm v Eisner*, 746 A.2d 244 (Del. 2009)). The business judgement rule is applied if there is evidence that the directors advising on a transaction were disinterested and independent. Otherwise an intermediate or entire fairness review is applied.

In the UK, the closest principle to the business judgment rule is the director's duty to "exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company" (*Re Smith & Fawcett* [1942] Ch 304 per Lord Greene). But in mergers and acquisitions in the UK, especially in takeovers, we are not *per se* looking at the interests of the company, but rather those of the shareholders. This is because of the way in which the Code applies.. As to the intermediate or entire fairness review in the US, this would equate to judicial review in the UK. In *Datafin,* (see below) however the courts held that judicial review of the Panel's decisions is to be historical rather than contemporaneous.

But the use of Independent Committees continues to raise questions. *Dole* raises the question of what steps Committees may take to protect the company from aggressive bidders acting in bad faith. It also reiterates the limits of Independent Committees when fraud is involved.

In *Re Dole Food Co Inc*, stockholders alleged that the transaction was unfair, and the court found in their favour. David Murdock owned 40% of Dole's shares, he was its Chairman and

CEO and *de factor* controller. He paid in November 2013 $13.50 per share for the remaining shares in Dole. Murdock initially offered $12 per share; and he conditioned the offer on approval by disinterested and independent directors (the "Committee"). In the stockholders litigation, the independence of the Committee was questioned. The Committee was made up of four: Conrad, Chao, Dickson, and Lansing – of these, Conrad was the Committee Chair, and had a long history of entanglements with Murdock. Yet, Vice Chancellor Laster found Conrad to be independent after hearing his testimonies. The court found that the committee had acted with integrity and independence. The Committee negotiated the increase from $12 to $13.50 per share, which was judged as a fair price.

As to the question of what a Committee can do about an aggressive bidder, such as Murdock, in some cases the Independent Committee might never be able to take enough steps to avoid an aggressive bidder, especially in cases such as *Dole* where the management gave false information to the Committee and acted fraudulently. If the bidder is not a controlling shareholder (or is not providing false information) then the Committee can take steps to advise on how best to defend the company (using post bid defences) and also help the management to meet the standards under the business judgment rule.

Dole also dealt with allegations of fraud. The facts show that, Murdock, through his right-hand man, Michael Carter, made false disclosure about savings Dole could realise after selling approximately half of its business. Carter provided the Committee with lowball management projections. The next day, in a secret meeting that violated the procedures established by the Committee, Carter gave Murdock's advisors and financing banks more positive and accurate data. Vice Chancellor Laster stated that, "what the Committee could not overcome, what the stockholder vote could not cleanse, and what even an arguably fair price does not immunize, is fraud;" and "Murdock and Carter deprived the Committee of the ability to negotiate on a fully informed basis and potentially say no to the Merger" (at 2-3).

On the effect of fraud, Vice Chancellor Laster reiterated a common law rule – fraud unravels everything. He found that "Carter engaged in fraud." He then said, "According to the common law nostrum, *fraus omnia corrumpit* – fraud vitiates everything. Here it rendered useless and ineffective the highly commendable efforts of the Committee and its advisors to negotiate a fair transaction that they subjectively believed was in the best interests of Dole's stockholders" (at 58). This rule can be traced back to a famous *dictum* of Denning LJ in the UK decision *Lazarus Estates Ltd v Beasley*, where he stated: "No court in this land will allow a person to keep an advantage which he has obtained by fraud. No judgment of a court, no order of a Minister, can be allowed to stand if it has been obtained by fraud. Fraud unravels everything" ([1956] 1 QB 702, 712). In *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank*, Lord Bingham reiterated the rule, "fraud is a thing apart. This is not a mere slogan. It reflects an old legal rule that fraud unravels all: *fraus omnia corrumpit*. It also reflects the practical basis of commercial intercourse. Once fraud is proved, 'it vitiates judgments, contracts and all transactions whatsoever'" ([2003] UKHL 6, 15).

Dole demonstrates that there is almost nothing an Independent Committee can do against fraud. The advice of Independent Committees is only as good as the information disclosed to them by the management of the company. Whilst the use of Independent Committees may clear boards of charges of unfairness in handling transactions, it cannot cure fraud. Yet, as long as Independent Committees remain unaware of undisclosed material information and are not involved in the fraud, their independence is likely to remain intact, as was the case in *Dole*.

INDEPENDENCE OF INDEPENDENT ADVISERS

In the UK, Rule 3.1 of the Code requires that the board of the offeree company must obtain competent independent advice as to whether the financial terms of any offer are fair and reasonable, and must make the substance of such advice known to its shareholders. In all cases, but especially in management buyouts or offers by controlling shareholders, the Panel stresses the independence of Independent Advisers. The Panel stresses that in such cases, "it is particularly important that the independence of the adviser is beyond question" (Code, Note 1 on Rule 3.1). In determining whether an Adviser is independent, the **[*102]** Panel examines the strength of the overall relationship between the offeror and the adviser and its group (Takeover Panel, Practice Statement 21, issued 7 March 2008).

The general approach of the Panel to the question of independence is not to apply settled strict rules as to what is independent, but to be flexible in reviewing all material facts of each case. The mischief to be avoided is conflict of interests, and the Panel must be satisfied that the Adviser's loyalty to the offeror does not conflict with their duty to provide the offeree with independent advice. The Panel will investigate all matters relevant to determining such independence. The Panel has always been at pains to stress the importance of early consultation where the independence of the Independent Adviser is likely to be questioned.

What will count as independent is a matter of fact finding on a case by case examination taking into account the changing circumstances. In 1995, the Panel was of the view that an Adviser, who has had a recent advisory role with the offeror or has a very close advisory relationship with a large shareholder in the offeree, would not be regarded as sufficiently independent (Takeover Panel, Annual Statement 1995). In the offer by Abbey National (as the offeror) for Cater Allen (as the offeree), the Panel ruled that Dresdner Kleinwort Benson, due to its "close, recent and continuing" advisory relationship with the offeror, would not be sufficiently independent to advise in the transaction (Takeover Panel, Annual Statement 1997). This approach has since been relaxed in light of changing circumstances. In 2008, the Panel was of the view that relationships between financial advisers and companies are in many cases less exclusive than was previously the case, and therefore concluded that it should be more flexible in its approach in determining the independence of an Adviser (Practice Statement, 7 March 2008). Examining all material information, the Panel is more likely than in the past to conclude that an Adviser is independent notwithstanding that it is currently advising, or had a recent advisory role with the offeror. Early consultation with the Panel remains paramount for parties.

It is unlikely that it would be open to parties in the UK to challenge the independence of Independent Advisers in court (in a few cases such as in *Marks & Spencer Group Plc v Freshfields Bruckhaus Deringer* [2004] EWCA Civ 741, issues have not turned on the independence of Advisers *per se* – in this case the issue of Freshfields' conflict of interest arose because it was acting for the bidder, rather than as Independent Adviser to the target). Compared to the US, Independent Committees are more likely to be scrutinised by the courts than their counterpart Independent Advisers in the UK. Issues arising out of takeover bids are resolved by the Panel, and the courts have historically been reluctant to intervene. The overarching reason for courts' reluctance is to dissuade parties from using tactical litigation to frustrate a takeover bid. That this is so is confirmed by Lord Denning MR's comment "the very moving for an injunction" is regarded by the courts as "an action designed to frustrate the making of the bid" (*Dunford & Elliot Ltd v Johnson & Firth Brown Ltd* [1977] Lloyd's Law Reports 505, 510).

In the landmark case of *Datafin*, the Court of Appeal ruled that the courts' relationship with the Panel is "to be historical rather than contemporaneous" – the courts would allow the Panel's "contemporary decisions to take their course, considering the complaint and intervening, if at all, later and in retrospect by declaratory orders which would enable the Panel not to repeat any error" (*R v Panel on Takeovers and Mergers ex part Datafin plc* [1987] QB 815, 842). Courts in the UK have long left takeover issues to be resolved by the Panel. In *Re Piccadilly Radio plc*, refusing the bidder's request for an injunction, the court was dismayed at the "regrettable tendency for the contestants in modern takeover battles to try to enlist the aid of the court" ((1989) 5 BCC 692, 706 per Millett J).

The practice of the Panel minimises the potential for the lack of independence of Advisers to adversely affect takeovers. The Panel proactively seeks to ensure that the independence of Advisers is beyond question. The Panel "strongly recommends early consultation with the Executive in any case where the independence of an adviser could be in doubt" (Takeover Panel, Annual Report 1995).

The statutory regime makes it very unlikely that parties would go to court to challenge the independence of Advisers. The Companies Act 2006 ("CA") gives the Panel powers to deal with all issues in takeover bids: the Panel's decisions are legally binding, and the Panel can make directions that must be complied with (CA ss 945, 946); a party not satisfied with the Panel's Executive decision may appeal to the Panel's Hearing Committee (CA s 951(1)); and if a party is still dissatisfied, they may further appeal to the Panel's Appeal Board (CA s 951(3)).

The foregoing suggests that, in the UK, whether an Independent Adviser is sufficiently independent, is a matter of fact for the Panel to decide on a case by case basis. In practice, early consultation and flexibility of the Panel makes it easy for parties to seek guidance on the question of independence of prospective Advisers. The UK legal regime empowers the Panel to deal with these issues and saves parties from expensive litigation.

CONCLUSION

This article has compared the use of Independent Committees in the US and Independent Advisers in the UK. The former have extensive roles in advising and negotiating transactions. With that greater role comes a higher risk of liability for unfairness in handling or advising the transaction with the result that US takeovers are more likely to be scrutinised by the courts.

In the UK, the Panel's more relaxed approach to the question of independence in the context of the relationship between financial advisers and the companies they advise, should give greater comfort to banks and financial institutions advising on M&A.